



DEFENSE CONTRACT AUDIT AGENCY
DEPARTMENT OF DEFENSE
8725 JOHN J. KINGMAN ROAD, SUITE 2135
FORT BELVOIR, VA 22060-6219

IN REPLY REFER TO

PAS 0-730.3a

November 16, 2000
00-PAS-096(R)

MEMORANDUM FOR REGIONAL DIRECTORS, DCAA
DIRECTOR, FIELD DETACHMENT, DCAA

SUBJECT: Audit Guidance on Assessments of Internal Controls at Service Organizations Used by Contractors

SUMMARY

In recent years, there has been a proliferation in the number of service organizations, and in the number of contractors using service organizations to process certain accounting transactions. Service organizations may provide services ranging from performing certain tasks under the direction of the user organization to replacing entire functions within the user organization. The services provided range from checking accounts and payroll processing to providing complete information technology services. Because many of the functions performed by the service organizations affect the user organization's financial data, FAO auditors performing audits at the user organization may need to obtain information about the services being provided, the related service organization's controls, and their effect on the financial data being audited.

While performing a risk assessment for incurred cost or systems audits, the FAO auditor needs to determine if a contractor (user organization) uses any service organizations, and if so, whether or not the auditor needs to gain an understanding of the service organization's controls. Statement on Auditing Standards (SAS) No. 70 requires that the auditor gain an understanding of the service organization's controls when (1) the service organization is part of the user organization's information system, (2) the service organization's controls are significant to the user organization's internal controls (i.e., controls are relevant to user cost objectives and costs affected by the service organization's controls are material), and (3) the degree of interaction between internal controls at the user organization and at the service organization is low.

If the FAO auditor needs to obtain an understanding of the controls at the service organization, but is unable to, the auditor will have to qualify the report or disclaim an opinion due to a scope limitation. If the auditor wants to assess control risk on the affected audit area below the maximum, he or she must be able to make a determination that the controls are operating effectively. As usual, if the controls are to be relied upon to reduce substantive testing, the controls themselves must be tested.

BACKGROUND

When contractors include service organizations as part of their information systems, the auditor must follow the procedures in SAS 70, *Reports on the Processing of Transactions by Service Organizations*, as amended by:

PAS 0-730.3a

SUBJECT: Audit Guidance on Assessments of Internal Controls at Service Organizations Used by Contractors

- SAS 78, *Consideration of Internal Controls in a Financial Statement Audit: An Amendment to SAS 55*, effective for service auditor's reports dated on or after January 1, 1997, and
- SAS 88, *Service Organizations and Reporting on Consistency*, which was issued in December 1999.

SAS 70 is incorporated into the Generally Accepted Government Auditing Standards (GAGAS) for financial related audits at GAGAS 4.39d and 5.36d. Our guidance relates primarily to factors a DCAA auditor should consider when performing a financial related audit of a contractor that uses a service organization to process certain transactions and related data.

DEFINITIONS

- Service organization – the entity (or in some cases, the segment of an entity) that provides financial services to the user organization (affects the user organization's financial data).
- Service auditor – the auditor who reports on the processing of transactions by a service organization. Because the services are often provided by an organization not affiliated with the contractor, DCAA typically lacks audit rights and may need to rely on the service organization's outside auditors.
- User organization – the entity that has engaged a service organization. This is the contractor location where DCAA is performing a financial related audit (typically incurred cost audits and systems audits).
- User auditor – the FAO auditor performing an audit at the user organization.
- Degree of interaction - the extent to which a user organization is able to and elects to implement effective controls over the processing performed by the service organization. When the degree of interaction is high, e.g., as with most commercial bank accounts, the user organization's controls effectively monitor the actions of the service organization.
- Relevant controls – the controls at the service organization that may affect the user organization's financial data.

GUIDANCE

During the initial phases of the risk assessment for incurred cost or systems audits, the FAO auditor needs to determine if a contractor (user organization) uses any service organizations. If so, the auditor must determine whether or not it is necessary to gain an understanding of the service organization's controls in order to plan the audit of the user organization. The auditor needs to gain an understanding of the service organization's controls only when:

1. The costs processed by the service organization are material,
2. The service organization is part of the user organization's information system, and
3. There is a low degree of interaction between the service and user organizations.

SUBJECT: Audit Guidance on Assessments of Internal Controls at Service Organizations Used by Contractors

If any of these conditions is not met, the auditor should plan the audit by focusing solely on the controls of the user organization. To determine whether the auditor must gain an understanding of the service organization's controls, answer these three questions:

1. Are the Transactions Processed by the Service Organization Material? – The auditor should determine whether or not the costs processed by the service organization are material to government contracts; if not, the auditor need not gain an understanding of the service organization's controls.

2. Is the Service Organization Part of the User Organization's Information System? - In making the determination of whether or not the service organization is part of the user organization's information system, the auditor needs to assess the relationship between the organizations. The service organization is part of the user organization's information system if the service organization can affect the user organization in any of the following ways:

- Initiate transactions for the user organization,
- Affect the user organization's accounting records or supporting information which underlies the cost reports,
- Involve itself in any part of processing the accounting information, from the initiation of the transaction to its inclusion in the cost data, or
- Affect the cost reporting process, including significant accounting estimates and disclosures.

If the service organization has no control over any of the above, then the service organization is not part of the user organization's information system, and the auditor need not gain an understanding of the service organization's controls.

3. What is the Degree of Interaction Between the Service and the User Organizations? – The degree of interaction refers to the extent to which a user organization is able to and elects to implement effective controls over the processing performed by the service organization. When the services provided by the service organization are limited to recording user organization transactions and processing related data, and the user organization retains responsibility for authorizing transactions and maintaining the related accountability, there will be a high degree of interaction. In such cases, the auditor should be able to plan the audit by focusing solely on the controls maintained by the user, and need not gain an understanding of the service organization's controls.

An example of a high degree of interaction would be payroll processing. The service organization receives time and attendance information from the user organization, prepares the payroll, writes the checks, etc. However, if once the service organization has processed the payroll, the user organization performs tests on the payroll to ensure its accuracy, there is little need to review the controls at the service organization since the user organization has satisfactory controls in place to ensure the accuracy of the payroll.

SUBJECT: Audit Guidance on Assessments of Internal Controls at Service Organizations Used by Contractors

On the other hand, if the service organization exercises independent judgment in initiating, processing, or reporting transactions without prior authorization of each transaction by the user, then the degree of interaction is low. In these cases, the user organization may not be able to implement effective controls over these transactions, and the auditor may need to obtain information about the service organization's controls in order to plan the audit.

An example of a low degree of interaction would be TRICARE's processing of health care claims for Blue Cross and Blue Shield. TRICARE has the authority to approve/deny claims on a case-by-case basis on behalf of Blue Cross and Blue Shield. In this case, the auditor of Blue Cross must obtain an understanding of the controls in place at TRICARE.

Gaining an Understanding of the Controls of the Service Organization – If it becomes necessary to gain an understanding of the relevant controls of a service organization (that is, if the affected costs are material, the service organization is part of the user organization's information system, and the degree of interaction is not high), the auditor needs to review information about the nature of the services provided by the service organization and the service organization's controls over those services. The auditor should start by reviewing the service agreement (contract) between the user and the service organization. This should be located in the permanent files but, if it is not available, should be requested from the contractor. Next, obtain the service auditor's report (if any) on the service organization's controls. The auditor can usually obtain this from the user organization or with the user organization's permission, request it from the service organization. These reports typically contain descriptions of the various controls that are in place and the independent auditor's opinion on the description of the controls.

If no service auditor's report, which adequately addresses the relevant controls, is available to the FAO auditor while planning the audit, the auditor should consider other information available at the user organization about the service organization's controls such as user manuals, system descriptions, technical manuals, and other policies and procedures. The auditor should also obtain and review any reports prepared by the service or user organization's internal auditors concerning internal controls over transactions and processes.

Problems may be encountered if the user organization either (1) has no information available concerning the service organization's controls and the service organization is not subject to DCAA audit, or (2) the information that is available at the user organization is not sufficient for the auditor to gain an understanding of the relevant controls. At this point, the auditor should again review the service agreement (contract) to determine what audit rights, if any, are contained in the document. Typically, these contracts allow the user organization limited audit rights. The auditor then must review the audit work the user organization performed (if any) and if it was adequate to provide an understanding of the service organization's controls. If no audit work was performed or it was inadequate, the auditor may request the user organization to perform or arrange for additional audit effort, or the auditor may request permission to visit the service organization and perform procedures there. Permission

PAS 0-730.3a

SUBJECT: Audit Guidance on Assessments of Internal Controls at Service Organizations Used by Contractors

must be obtained from both the user organization and the service organization. If the service organization is subject to DCAA audit, the auditor should request an assist audit. If the auditor is unable to obtain a sufficient understanding of the controls to achieve his or her audit objective, the auditor must qualify or disclaim an opinion on the affected costs.

Relying Upon Service Organization Controls – After gaining an understanding of the service organization's controls (if so required), the auditor may then choose to rely upon specific service organization controls to reduce the control risk below the maximum on the audit he/she is performing at the user organization. If so, the user auditor should obtain evidential matter that would allow the user auditor to reduce the assessed level of control risk below the maximum. This evidential matter may be obtained from:

- the service auditor's report, if the service auditor performed tests of the controls' effectiveness, and the report may be relied upon (CAM 4-1000),
- appropriate tests by the user auditor of the user organization's controls over the activities of the service organization, or
- direct tests by the user auditor of the service organization's controls.

After considering the above information, the auditor should have sufficient evidence to determine if the internal controls in place at the service organization can be relied upon, and to determine the impact of this on the risk associated with the audit of the user organization. As usual, if there are any control deficiencies noted that affect transactions performed for the user organization, the auditor must assess the impact of these deficiencies on the audit scope.

CONCLUDING REMARKS

The enclosure contains the audit steps to be followed in order to consider the impact of SAS 70. The APOVER80 audit program was revised in the October 2000 Quarterly APPS/DIIS Update to reflect these audit steps.

Field audit office personnel should direct any questions regarding this memorandum to their regional offices. Regional personnel should direct questions to Mr. Kenneth W. Anderson, Program Manager, Auditing Standards Division at (703) 767-3274, fax (703) 767-3234, or e-mail at dcaa-pas@dcaa.mil.

/s/

Lawrence P. Uhlfelder
Assistant Director
Policy and Plans

Enclosure
a/s

DISTRIBUTION: C

SAS 70 Audit Steps

In planning the audit, consider the impact of SAS 70, *Reports on the Processing of Transactions by Service Organizations*, as amended by SAS 88, *Service Organizations and Reporting on Consistency*, on audit scope by performing the following audit steps:

1. Determine if the contractor (user organization) uses any service organizations.
2. If so, determine if the transactions processed by the service organization are material.
3. If so, determine if the service organization is part of the user organization's information system.
4. If so, determine the degree of interaction between the service organization and the user organization. If high (as in the case of payroll processing, where the service organization receives time and attendance information from the user organization, prepares the payroll, writes the checks, etc. and then the user organization performs tests of the processed payroll for accuracy) there is no need to obtain an understanding of the service organizations controls. If low (as when a trustee manages pension assets):
 - a. Obtain and review the service agreement (contract).
 - b. Obtain and review the service auditor's report (if any).
 - c. If necessary, obtain and review other information available at the user organization including user manuals, system descriptions, technical manuals, and other policies and procedures.
 - d. If necessary, obtain and review any reports prepared by the user or service organizations' internal auditors relating to internal controls over transactions and processes.
 - e. If necessary, and with appropriate permission, visit the service organization and perform procedures or request an assist audit.
5. Summarize effects of review of service organizations on scope of current audit.